



## Treasury Inspector General for Tax Administration

### **SIGNIFICANT CHALLENGES EXIST IN DETERMINING WHETHER TAXPAYERS WITH SCHEDULE C LOSSES ARE ENGAGED IN TAX ABUSE**

Issued on September 7, 2007

## Highlights

Highlights of Report Number: 2007-30-173 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

### **IMPACT ON TAXPAYERS**

A number of taxpayers who have other significant income sources reduce their taxable incomes by reporting losses on a U.S. Individual Income Tax Return (Form 1040) Schedule C (Profit or Loss From Business). About 1.5 million taxpayers, many with significant income from other sources, filed Form 1040 Schedules C showing no profits, only losses, over 4 consecutive Tax Years (2002 – 2005); 73 percent were assisted by tax practitioners. By claiming these losses to reduce their taxable incomes, about 1.2 million of the 1.5 million taxpayers potentially avoided paying \$2.8 billion in taxes in Tax Year 2005. Changes are needed to prevent taxpayers from continually deducting losses in potential not-for-profit activities to reduce their tax liabilities.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated because the Internal Revenue Service (IRS) estimates incorrect deductions of hobby expenses account for a portion of the overstated adjustments, deductions, exemptions, and credits that result in about \$30 billion per year in unpaid taxes. TIGTA conducted the audit to determine what actions the IRS is taking to address this potential noncompliance.

### **WHAT TIGTA FOUND**

Internal Revenue Code (I.R.C.) Section (§) 183 (Activities not engaged in for profit), also referred to as the "hobby loss" provision, and related Treasury Regulation § 1.183-1 do not establish specific criteria for the IRS to use to determine whether a Schedule C loss is a legitimate business expense without conducting a full examination of an individual's books and records. The purpose of the hobby loss provision was to limit the ability of wealthy individuals with multiple sources of income to apply losses incurred in "side-line" diversions

to reduce their overall tax liabilities. Our analysis showed 332,615 high-income taxpayers received the greatest benefit by potentially avoiding approximately \$1.9 billion in taxes for Tax Year 2005.

The I.R.C. and Treasury Regulation do not require a taxpayer to have a reasonable expectation of profit; rather, the taxpayer needs just the "objective" of making a profit. I.R.C. § 183 makes it difficult for the IRS to efficiently administer tax law that ensures taxpayers are not deducting not-for-profit losses to reduce their taxes on other incomes year after year.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended the Commissioner, Small Business/Self-Employed Division, provide a copy of this report to the Department of the Treasury, Office of the Assistant Secretary for Tax Policy, to consider proposal of legislative changes to I.R.C. § 183. The proposal should include establishing a clearly defined standard or bright-line rule for determining whether an activity is a business or a not-for-profit activity. Due to the large number of these tax returns being prepared by tax practitioners, TIGTA also recommended the Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division, continue to coordinate with practitioner organizations to encourage compliance with existing provisions.

In their response to the report, IRS officials stated they agreed with the recommendations and plan to take appropriate corrective actions. The Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division, plans to coordinate with the Office of Legislative Affairs to forward a copy of the final report to the Department of the Treasury Office of Tax Policy and to include key messages and talking points about I.R.C. § 183 tax obligations as a Fiscal Year 2008 outreach initiative directed to practitioner organizations.

### **READ THE FULL REPORT**

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2007reports/200730173fr.pdf>.

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